No. 14515

United States
Court of Appeals
for the Ninth Circuit

WESTERN PACIFIC RAILROAD CORPORATION and ALEXIS I. DU PONT BAYARD, Receiver,

Appellants.

vs.

WESTERN PACIFIC RAILROAD COMPANY, JAMES FOUNDATION OF NEW YORK, INC., and WESTERN REALTY COMPANY,

Appellees.

Transcript of Record

Appeals from the United States District Court for the Northern District of California, Southern Division.

Phillips & Van Orden Co., 870 Brannan Street, San Francisco, Calif.—9-24-54

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Phillips & Van Orden Co., 870 Brannan Street, San Francisco, Calif.—9-24-54

In the District Court of the United States for the Northern District of California, Southern Division

Civil Action No. 33514

WESTERN PACIFIC RAILROAD CORPORATION and ALEXIS I. DU PONT BAYARD, Receiver,

Plaintiffs,

vs.

WESTERN PACIFIC RAILROAD COMPANY, JAMES FOUNDATION OF NEW YORK, INC., and WESTERN REALTY COMPANY,

Defendants.

AMENDED BILL OF COMPLAINT

To the Honorable, the Judges of the District Court of the United States for the Northern District of California, Southern Division:

The Amended Bill of Complaint (hereinafter referred to as the complaint) of Western Pacific Railroad Corporation and Alexis I. du Pont Bayard, Receiver, respectfully shows:

First: Western Pacific Railroad Corporation is a corporation duly organized and existing under the laws of the State of Delaware, and Alexis I. du Pont Bayard is Receiver of Western Pacific Railroad Corporation duly appointed by the Chancery Court of the State of Delaware in and for the County of New Castle (hereinafter referred to as the plaintiffs); and both of said plaintiffs are citizens and residents of the State of Delaware.

Second: The Western Pacific Railroad Company was the original petitioner in the reorganization proceedings under Section 77 of the Bankruptcy Act numbered 26591-S on the docket of this Court, the history of which, so far as material to this complaint and except as amplified herein, is judicially stated and found by the Honorable Louis E. Goodman, United States District Judge, in a certain action in this Court entitled, "Western Pacific Railroad Corporation, et al., vs. Western Pacific Railroad Company, et al., No. 26508—Civil," to be as follows:

"Plaintiff is The Western Pacific Railroad Corporation; its subsidiary was Western Pacific Railroad Company, an operating railroad company, herein referred to as the 'debtor'; defendant, the reorganized subsidiary is The Western Pacific Railroad Company.

"Statement of Facts

"Plaintiff corporation, a so-called holding company, from 1916 to April 30, 1944, owned all the outstanding capital stock of the debtor. For some years prior to 1935, the financial condition of the debtor had been steadily worsening. In 1935 it filed a petition under Section 77 of the Bankruptcy Act (11 USC 205) and this Court in that year placed its affairs in the hands of trustees. Thereafter a plan of reorganization was proposed and in 1939 it was approved by the Interstate Commerce Commission, 233 ICC 409. Inter alia, it was determined in the plan that the capital stock of the debtor owned by the plaintiff was without equity or value

and that plaintiff and its stockholders therefore were not entitled to participate in the plan. In 1940 this Court approved the plan of reorganization, including approval of the findings of the Interstate Commerce Commission as to the worthlessness of the plaintiff's equity. The Circuit Court of Appeals (now Court of Appeals) of the Ninth Circuit reversed in 1941 (124 F. 2d 136). In 1943 the Supreme Court reversed the Circuit Court and affirmed the order of the District Court (318 U. S. 448). It there considered and rejected the contention of the plaintiff that it should have the right to participate in the plan because of recent increased earnings of the debtor (318 U. S. 508, 509).[1] Thereafter, the plan of reorganization was, in accordance with the statutory provisions (11 USC 205e), submitted to the creditors, and, after their approval, the plan was confirmed on October 11, 1943, by this Court. The reorganization committee designated in the plan of reorganization, instead of forming a new corporation, determined to use the corporate structure or shell of the old company (debtor) and to execute the plan of reorganization by revesting its former properties in the reorganized company, i.e., the defendant. On November 22, 1943, an agreement was made between the plaintiff, its secured creditors and the reorganization committee wherein a modus of revesting was set up. Among other things, the plain-

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"[1]See in re Denver & R. G. W. R. Co. 10 Cir. 150 Fed. 2d 28 and F. F. C. v. D. & R. G. R. Co. 328 U. S. 495, where similar holdings upon similar contentions were made.

no net income. The validity of the offsets was questioned by the Commissioner of Internal Revenue and conferences were had between the tax counsel for the defendant and the Commissioner. As a result, a tax settlement was made with the Commissioner whereby, in consideration of the withdrawal of the claim for refund, the Commissioner accepted and approved the returns. The nature and basis of this compromise settlement will be hereafter more fully discussed.

"Subsequent to the filing of the claim for refund of the 1942 tax paid, and the filing of the consolidated tax returns for 1943 and part of 1944, and after negotiations for the settlement of the entire tax issue with the Commissioner of Internal Revenue had started, the plaintiff, on October 10, 1946, filed its bill of complaint in equity herein. In substance the bill of complaint recited the filing of the claim for refund, the commencement of the negotiations for the approval of the consolidated returns and prayed that the Court settle the proprietary rights of the plaintiff and the defendant in the tax saving involved. It was further prayed that funds equivalent to the tax savings be placed in the custody of the court for proper and equitable distribution.[4]

"On April 7, 1947, the Court permitted the filing of a complaint in intervention on behalf of certain

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"[4]The debtor had on two separate occasions set aside reserve funds for the payment of the taxes, to protect against the contingency of adverse ruling by Commission or Court.

stockholders of the plaintiff who wished to join in the demand of the plaintiff and in its prayer for relief against the defendant. The settlement and agreement with the Commissioner, by which the claim for refund was withdrawn and the consolidated returns for the years 1942, 1943 and part of 1944 were accepted and approved, was consummated on August 14, 1947.

"On December 17, 1947, plaintiff filed a supplemental bill of complaint, wherein the consummation of the settlement and compromise was set forth. It was there further alleged that the defendant through its officers and attorneys had controlled the board of directors of the plaintiff corporation and that by reason of such control plaintiff was caused to file the consolidated return for the benefit of the defendant. Throughout the proceedings and in the trial, this has been referred to as 'duality of control.'

"In the supplementary complaint, the plaintiff prayed that the Court, in equity, enter a decree allocating and directing the payment of the abated taxes, amounting to some $17,000,000, to the plaintiff by way of mitigation of its losses in its subsidiary.

"After many preliminary motions were made and disposed of, and after the filing of answers by the defendant and after pre-trial conferences, the cause finally came on for trial.

"The trial itself consumed 13 days; the proceedings are set forth in 1700 pages of transcript; 14 witnesses testified and 164 exhibits, with various subdivisions, were introduced in evidence.

"A number of special defenses were pleaded and testimony and exhibits offered at the trial in support thereof.

"But I am of the opinion, in view of the fact that the cause is concededly of equitable cognizance, that decision must depend upon the essential righteousness of plaintiff's claim as an equitable demand.

"Discussion

"The income tax picture presented is bizarre indeed. It is 'paradoxical,' as the defendant's tax attorneys put it.[5] The Western Pacific Railroad Company, the operating company, profitably conducted its railroad facilities in reorganization during 1942, 1943 and the forepart of 1944. Its own profit and loss records showed the debtor to be accountable to the United States in the sum of $21,346,567 income taxes for the years 1942, 1943 and the first four months of 1944. During this same period of time the plaintiff was still the legal owner of all the capital stock of the debtor, an ownership which had been declared by both the Interstate Commerce Commission and the Reorganization

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"[5]In a letter dated May 20, 1943 (plff. Ex. 50), addressed to Curry, Vice President of defendant company, tax counsel Polk set forth his idea of using the plaintiff's stock loss in the debtor to offset debtor's profits, saying: 'This is commented upon rather than suggested, since it is paradoxical to compute a loss upon the operating company's stock which, through the mechanics of consolidated return reporting, could be used to nullify the very income of the affiliate whose stock had become worthless.' (Interlineation supplied.)

Court to be valueless. But the tax attorneys for the defendant conceived a 'paradoxical' plan. They decided that they would file, pursuant to Section 141 of the Internal Revenue Code and the Treasury Regulations issued thereunder[6] affiliated or consolidated returns on behalf of the parent company and its subsidiaries and in them set up the plaintiff's stock loss (i.e., its ownership in the debtor) as an income tax deduction against the operating profits. Ostensibly they found their authority for so doing in Section 123 of the Revenue Act of 1942 (26 USC Sec. 23(g)4).[7] Thus, part of the lost $75,000,000 stockholding of the plaintiff in the debtor was applied as an offset to operating profits during each of the three years in question to the end that no part of the $21,346,567 tax would be paid.

"This was more than mere tax 'saving'; it amounted to a complete tax 'escape.' But the debtor had already paid $4,144,828 income taxes for the fiscal year 1942 and it had filed a claim for refund of such taxes upon the ground that it owed no taxes for 1942 if, on the theory of 'carry-back,' part of the $75,000,000 stock loss was a proper deduction. So in order to make the far larger saving or 'escape' offered for the three years in question, the claim for refund was waived and the Commissioner then

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"[6]Sec. 141 Internal Rev. Code permits the filing of a consolidated return by affiliated corporations. Regulations 104 and 110 contain detailed requirements for such filing.

"[7]See footnote # 3.

accepted the returns for 1942-1943 and the fore part of 1944. The effect of this was that the debtor paid $4,144,828 taxes to the United States in order to escape the $21,346,567 previously mentioned, or a net saving or 'escape' of $17,201,739. To all of this the Commissioner agreed. It was stated to be a compromise because of some question as to the date of definite ascertainment of the stock loss. The Commissioner apparently agreed that, under the 1942 amendment (Sec. 23(g)4), it was proper to offset the capital stock loss against the net operating gain, and the taxpayer paid $4,144,828 to resolve some alleged uncertainty as to the date of ascertainment of the stock loss.[8]

"How the amendment to the statute, Sec. 23(g)4), could have been availed of by the debtor is, mildly stated, puzzling, if not downright amazing. Its application in an orthodox case is understandable. The theory of deducting a loss in an economic aggregation of affiliated corporations, where one unit gains and the other unit loses, has been recognized and approved by Congress and the Courts.

"Prior to the Revenue Act of 1938, losses resulting from the worthlessness of stocks and bonds were deductible from ordinary income and were not subject to the so-called capital-loss limitations. These

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"[8]It is not at all clear to the Court how the alleged uncertainty as to the date of ascertainment of the stock loss could have been a true factor affecting the tax settlement inasmuch as any such uncertainty would, if it existed, as well apply with respect to the 1943 and 1944 returns."

limitations, that is that a capital loss could only offset a capital gain, had applied only to sales and exchanges, with the result that it was more advantageous to allow stocks, that might become worthless, to become worthless rather than to sell them. By the 1938 Act losses sustained by reason of the worthlessness of securities were treated as if they resulted from the sale or exchange of capital assets and thus were subject to the limitations applying to deductions in the form of capital losses, 26 USC 23(g)4, which was Section 123 of the Revenue Act of 1942, accorded losses on worthless stocks held by a taxpayer in affiliated corporations the same treatment accorded losses from all worthless securities prior to the Revenue Act of 1938."

Third: As the result of the various steps outlined in the foregoing quoted part of the opinion of the District Court, which was formally adopted by the District Court as its Findings of Fact, a net fund amounting to $17,201,739 is in the possession of the Western Pacific Railroad Company, having been transferred to it by Thomas M. Schumacher and Sidney Ehrman, Trustees, subject to an Assumption Agreement whereby it assumed:

"Generally any and all liabilities and obligations with respect to claims of any character whether heretofore or hereafter asserted arising out of the possession, use or operation of the debtor's property by the said Trustees, or their conduct of the debtor's business."

Fourth: The Plan of Reorganization of the debtor referred to in the opinion quoted above was cer-

tified to the District Court by the Interstate Commerce Commission June 21, 1939, and was approved by the District Court August 15, 1940, at a time when a loss resulting from the worthlessness of securities owned by a holding corporation, in which category petitioner Western Pacific Railroad Corporation belongs, could be offset only against capital gains occurring in the same tax period, but on October 21, 1942, Congress inserted in the following provision of the Internal Revenue Code forming part of Section 23 the paragraph thereof numbered (g)(4):

"Deductions from gross income. In computing net income there shall be allowed as deductions:

"* * *

"(g)(2) Securities becoming worthless. If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange on the last day of such taxable year of capital assets.

"* * *

"(4) Stock in affiliated corporations. For the purpose of paragraph (2) stock in a corporation affiliated with the taxpayer shall not be deemed a capital asset. For the purpose of this paragraph a corporation shall be deemed affiliated only if:

"(A) At least 95 per centum of each class of its stock is owned directly by the taxpayer; and * * *"

Fifth: The enactment of the foregoing Section

23(g)(2)(4) on October 21, 1942, authorizing restoration out of consolidated taxable income of the lost capital of the parent invested in the securities of a subsidiary could not have been reasonably anticipated or foreseen by the Interstate Commerce Commission on June 21, 1939, when it certified the Plan of Reorganization to this Court, and on October 10, 1946, the plaintiffs Western Pacific Railroad Corporation filed in this Court the suit hereinbefore referred to (in which suit at a subsequent stage Alexis I. du Pont Bayard was added as an additional plaintiff) against Western Pacific Railroad Company, the debtor in the Bankruptcy proceedings 26591-S and the obligor under the Assumption Agreement hereinbefore mentioned, and also against the additional parties named in the subjointed footnote as defendants,* praying an accounting by the reorganized Western Pacific Railroad Company in respect of the use under federal consolidated income and excess profits tax returns of the plaintiffs' tax credit in the amount necessary to effect a relinquishment of its taxable income up to $17,201,739 under Section 23(g)(2) and (4) set out above. The subsequent history of this accounting proceeding and the antecedent history of Section 77 proceeding for the reorganization of the debtor Railroad Company are within the judicial knowl-

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*The Sacramento Northern Railway, Tidewater Southern Railway, Deep Creek Railroad Company, The Western Realty Company, The Standard Realty and Development Company, and Delta Finance Company, Ltd.

edge of this Court, as revealed by the official reports in chronological order cited below.*

Sixth: Under the Internal Revenue Code and the Regulations of the Treasury of the United States thereunder, the plaintiff Western Pacific Railroad Corporation was free to join or refuse to join in consolidated returns as it saw fit, and was under no statutory duty to file consolidated returns and was free to make its own decision whether to file or not to file on the basis of its own interests.** But the Court of Appeals held (Judge Fee dissenting) in response to repeated assertions of the defendant Railroad Company that it had not paid its pre-reorganization debts and that the plaintiff Western Pacific Railroad Corporation was under an equitable duty as fiduciary to join in consolidated re-

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*Western Pacific Railroad Company Reorganization, 230 I.C.C. 61; 233 I.C.C. 409; in re Western Pacific Railroad Company, No. 26591-S, 34 F. Supp. 493; Western Pacific Railroad Company vs. Reconstruction Finance Corporation, et al., and four other cases, No. 9712, 124 Fed. 2d 136 (1941); Ecker and others vs. Western Pacific Railroad Corporation, et al., 318 U. S. 418 (1943); Western Pacific Railroad Corporation vs. Western Pacific Railway Company, et al., No. 26508, 85 F. Supp. 869 (1949); Western Pacific Railroad Corporation, et al., v. Western Pacific Railroad Company, et al., 197 Fed. 2d 994 (1951); Western Pacific Railroad Corporation, et al., v. Western Pacific Railroad Company, et al., 345 U. S. 247 (1953); and after remand 205 Fed. 2d 374, 206 Fed. 2d 495.

**Treasury Regulation 109, Sec. 23—16a and 11a —Duke Power Company v. Commission, 44 Fed. 2d 543, 545 (4 Circuit).

turns and thereby donate its tax credit and the avails thereof to the reorganized defendant Railroad Company because its creditors had not been fully paid. The following is from the prevailing opinion written by Judge Byrne:

"The Corporation was the sole owner of the subsidiary's (the debtor's) capital stock. As such it was under a duty to deal fairly with the subsidiary, having full regard for the interests of the creditors and holders of other securities. Consolidated Rock Products Co. v. Du Bois (312 U. S. 510). It owed a duty not to require the subsidiary to forego a legitimate tax saving and could not bargain to perform its duty. * * * If Corporation had required tribute as a condition of its co-operation then it would have been acting with less than the required standard of fairness to the subsidiary's creditors."

The plaintiffs are bound by and accept this determination of the Court of Appeals, and their purpose and objective in filing this successoral complaint is to provide the essential machinery or medium for implementing it and requiring the reorganized Western Pacific Railroad Company, as in duty bound under its Assumption Agreement as the trustee-custodian of the fund also to accept it and to carry it into effect.

Seventh: The doctrine of Consolidated Rock Products Company vs. Du Bois (312 U. S. 510) is that junior interests in a bankruptcy or equity administration proceeding cannot be given any part or securities representing any part of the debtor's estate unless and until full compensatory treatment

is given for the entire bundle of rights which the senior creditors surrender. In the proceeding 26591-S, the Plan of Reorganization approved by this Court and by the Supreme Court of the United States allotted to the senior creditors, in full satisfaction of their claims, securities representing in the determination of the Interstate Commerce Commission and of the Court the full value of their claims without resorting to an excess value of the senior liens which they surrendered; and thereupon gave a residue valued at $5,964,296 to creditors secured by liens wholly subordinate to the liens held by the senior creditors. It is accordingly res adjudicata in the proceeding 26591-S that any fiduciary duty of the plaintiffs Western Pacific Railroad Corporation to donate its special tax credit, or taxes remitted there against, under Section 23(g)(2)(4) is one to be exercised for the exclusive benefit of the creditors of the debtor Western Pacific Railroad Company left unprovided for or inadequately provided for under the Plan of Reorganization approved by the Supreme Court of the United States in Ecker vs. Western Pacific Railroad Corporation, 318 U. S. 448.

Eighth: In the exercise of its jurisdiction in the proceedings 26591-S, the Interstate Commerce Commission determined the amount of the indebtedness of the debtor as of January 1, 1939, for which full compensatory treatment was not accorded under the Plan of Reorganization to be $13,914,530, of which $6,249,750 was due and owing to the A. C. James

Company; $7,609,370 was due and owing to the plaintiff Western Pacific Railroad Corporation, and $60,410 was due and owing to Western Realty Company. The claim of the A. C. James Company was liquidated in part out of collateral pledged by the debtor (junior lien bonds of the debtor or new securities issued thereagainst and substituted therefor) and the unliquidated balance as shown by an exhibit introduced by the defendant Railroad Company in said action "No. 26508 Civil" is $3,495,000 but is subject to adjustment bringing it up to $3,683,175.* In addition to the creditor claims so determined and allowed by the Interstate Commerce Commission the claim of plaintiff Western Pacific Railroad Corporation as owner of all of the debtor's preferred stock was allowed in the amount in excess of $40,000,000.**

Ninth: As hereinbefore alleged the plaintiffs are

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*In the exhibit introduced by the defendant Railroad Company to establish the deficiency of the A. C. James Company, it was charged with 37,635 shares of new common stock at $62 instead of its true currency value of $57 as fixed by the treatment accorded the senior lien creditors—exhibit (defendant's) No. 33, record page 2022.

**A secured claim of Railroad Credit Corporation was fully liquidated by the use of common stock pledged at $62 per share and certain Accommodation Collateral supplied by Western Pacific Railroad Corporation, the unused balance of which Accommodation Collateral was restored to Western Pacific Railroad Corporation under a decree of the Chancery Court of the State of Maryland.

filing this complaint as an independent or successoral action in equity to provide an essential machinery or medium for implementing the decree or judgment in said action "No. 26508 Civil" and for an administration of the trust arising thereunder or in consequence thereof and as a civil action in equity between citizens of different states, viz., the plaintiffs Western Pacific Railroad Corporation and Alexis I. Du Pont Bayard, Receiver, both being citizens and residents of the State of Delaware and Western Pacific Railroad Company, a corporation, organized and existing under the laws of the State of California, as a defendant, wherein the amount in controversy greatly exceeds $5,000.00.

Tenth: James Foundation of New York, Inc., successor to the creditor position of A. C. James Company, is a corporation of the State of New York; and Western Realty Company is a corporation of the State of Colorado, and each being an unsatisfied creditor of the debtor, and as such a beneficiary of the trust created as hereinbefore alleged, is an interested but not an indispensible party to this proceeding, and being such both also have been named as parties defendant herein.

Eleventh: The reason why this complaint was not filed at a earlier date is that the status of the $17,201,739 fund in the custody of the reorganized Western Pacific Railroad Company, defendant herein, was not finally established until the denial of the second petition for certiorari at the present term of the United States Supreme Court in said

action in this Court entitled, "Western Pacific Railroad Corporation, et al., vs. Western Pacific Rr. Co., et al., No. 26508-Civil."

Twelfth: While said second petition for certiorari was pending in the United States Supreme Court on application for rehearing, the plaintiff receiver wrote the President of the defendant Railroad Company as follows:

"If the Supreme Court denies our pending petition for a rehearing of the application for certiorari and establishes the position taken by your counsel throughout the litigation that the $17,000,000 fund in your custody is a trust fund for the satisfaction of the unpaid creditors of your company (pre-reorganization) it is our purpose to apply to the Bankruptcy Court for a proper application of the fund to that purpose. I am writing this in advance to put you and your directors on notice of our position."

No reply to or acknowledgment of said communication has been received by the plaintiffs but they are informed and allege that the defendant Railroad Company proposes to divert the fund to purposes other than the payment and satisfaction of claims of partially paid and wholly unpaid (pre-reorganization) creditors of the defendant Railroad Company and to utilize it for the enrichment of the creditors, and successors in interest of creditors that received full compensatory treatment under the Plan of Reorganization.

Wherefore, the plaintiffs pray:

(1) That this Court make cognizance of this cause and grant unto them a writ of subpoena of the United States directed to Western Pacific Railroad Company, James Foundation of New York, Inc., and Western Realty Company, named as defendants herein, service upon the two defendants last named to be made by the Marshal of the District wherein personal service may be effected;

(2) That this Court grant unto the plaintiff a judgment or decretal order adjudging that the fund of $17,201,739 in the possession of the reorganized Western Pacific Railroad Company is held by it subject to the Assumption Agreement executed by it pursuant to the order and decree of this Court in the proceeding 26591-S, and is held by it in trust for the benefit of the unpaid and unsatisfied creditors of the debtor in said proceeding 26591-S in order of their respective priorities and for the interests junior thereto as heretofore determined by the Interstate Commerce Commission;

(3) That this Court enter a preliminary order placing said fund of $17,201,739 in judicial custody and requiring and directing the defendant Western Pacific Railroad Company to hold said fund subject to the further order or orders of this Court which may include an order or orders providing therefrom currently for the expenses of the plaintiffs and their attorney and counsel in resisting the threatened conversion thereof; and

(4) That the plaintiffs may have such further relief by way of declaratory judgment or decree of

injunction, temporary or permanent, or both, or otherwise as to the Court may seem meet.

Dated: May 4, 1954.

WESTERN PACIFIC RAILROAD CORPORATION and ALEXIS I. DU PONT BAYARD, RECEIVER,

Plaintiffs;

By /s/ LEROY R. GOODRICH,
Their Attorney.

/s/ FRANK C. NICODEMUS, JR.,
/s/ WILLIAM MARVEL,
Counsel.

Affidavit of Service by Mail attached.

[Endorsed]: Filed May 5, 1954.

[Endorsed]: No. 14515. United States Court of Appeals for the Ninth Circuit. Western Pacific Railroad Corporation and Alexis I. Du Pont Bayard, Receiver, Appellants, vs. Western Pacific Railroad Company, James Foundation of New York, Inc., and Western Realty Company, Appellees. Transcript of Record. Appeals from the United States District Court for the Northern District of California, Southern Division.

Filed September 16, 1954.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the Ninth Circuit.